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Canada. Office of the Auditor General  
Auding what isn't  
(Discussion paper no. 36)





Office of the  
Auditor General  
of Canada



Bureau du  
vérificateur général  
du Canada

DISCUSSION PAPER NO. 36

AUDITING WHAT ISN'T

by

Dan Rubenstein

August 1984

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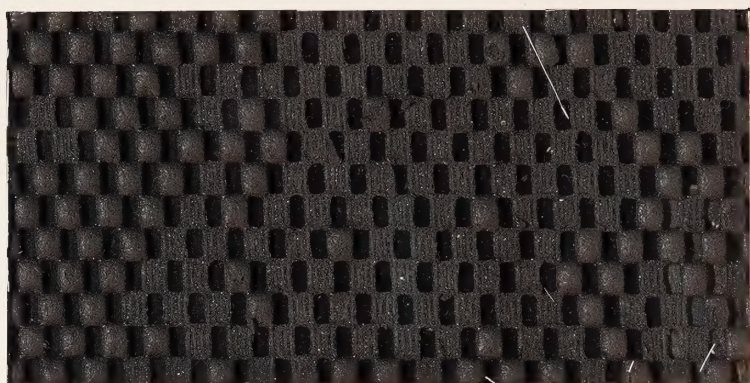
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## **Auditing What Isn't**

According to the Comprehensive Auditing Foundation of Canada, a comprehensive audit is an examination that "provides an objective and constructive assessment of the extent to which (1) financial, human and physical resources are managed with due regard to economy, efficiency and effectiveness; and (2) accountability relationships are reasonably served". A comprehensive audit, therefore, examines both financial and management controls, including information systems and reporting practices, and recommends improvements where appropriate.

That description of comprehensive auditing is fine, but I believe it does not go far enough. The definition assumes the existence of management controls, but what if they do not exist? This article argues that comprehensive auditing should also be concerned with the absence of expected management controls. In short, if auditors suspect that a control that should be in place is not, the first step is to prove its absence, the second to quantify the impact of the lack of that control, then to determine the cause and, finally, to make appropriate recommendations to the management involved.

**"Using models to gain the knowledge of business necessary to comprehensively audit what is, as well as what isn't".**

The key to effectively discharging these audit responsibilities is a dynamic and well-integrated knowledge of the business. The required knowledge blends the realities of "what is" with a preconceived sense of "what should be," that is, it combines descriptive realities and normative models. Auditors therefore audit what isn't, as well as what is; that is, they audit the less obvious sins of omission, as well as the more traditional sins of commission.

A useful technique for such an approach to comprehensive auditing is modelling because it provides structure for a comprehensive audit while recognizing the uniqueness of each entity. Modelling evolves from a preconceived notion of how the audit entity should ideally be operating to maximize the





delivery of results and minimize waste. By comparing the actual operation with the model, the auditor can identify and subsequently diagnose deficiencies in the operations of the entity.

### **What is comprehensive auditing?**

If we review the definition of comprehensive auditing given at the beginning of this article, we find that it emphasizes "due regard to economy, efficiency and effectiveness". Simply stated one of the objectives of a comprehensive audit is to identify opportunities for the government to achieve the best services for the money spent and to make constructive recommendations on ways to improve any wasteful practices noted. The audit, therefore, will normally focus on:

- Lack of economy -- caused by, for example, purchasing goods at the wrong time, at the wrong price, of inferior quality, or in the wrong quantities, or by failing to obtain sufficient revenues for services rendered to the public.
- Lack of efficiency -- caused by using too many people and other resources to produce too few results.
- Lack of effectiveness -- caused by doing the wrong thing altogether.

In contrast to financial auditors, comprehensive auditors do not start with a set of financial statements or well-defined reporting conventions (GAAP). Rather, comprehensive auditors have to:

- Address "softer" management issues where there are few commonly accepted ground rules on how to achieve results.
- Identify the rules or criteria, to be used to evaluate the data collected relative to each issue.



- "Sell" their opinion, that is, present the opportunity cost of not following recommendations on how to achieve greater service for the same cost, or the same level of service for a lower cost.

Preparing a model of the entity helps comprehensive auditors gather, organize and communicate the dynamic knowledge of the business required to successfully meet those audit challenges.

### **Required knowledge of the business**

During the crucial planning phase of a comprehensive audit, it is essential that auditors acquire a knowledge of the particular entity being audited, as well as a general familiarity with the industry in which the entity operates. That knowledge must be broad, accurate, thorough and incisive. Auditors must determine:

- What business the client is really in.
- The essential elements of the business, the infrastructure of the business, the crucial interactions that transform resource inputs into desired outputs in the form of products or services and the operating environment.
- The control framework established by auditee management.

The auditor first addresses the basic question: "What business is the client really in?" The need for this clarification usually arises in public-sector comprehensive audits of a department or program. A multiplicity of goals, objectives or activities often obscures the entity's *raison d'être*. Consider, for example, a lender of last resort making economic development loans to socially disadvantaged groups. Is the program in the welfare business or the loan business? As the audit approach will differ accordingly, auditors need to identify the real business.





As well, the essential elements of the program must be clearly defined. These elements include:

- The entity's mandate and any related authorities; the why of its existence.
- The entity's operating environment and key opportunities and constraints.
- The entity's organizational structure and modus operandi.
- The entity's principal program delivery systems.
- The entity's principal results in terms of products, services or general benefits, as well as the principal types of resources consumed to achieve these results.

The auditor then reviews the management control framework established by auditee management to ensure the utilization of resources in compliance with managements' objectives and goals.

That information becomes the raw material for the development of an appropriate audit model. Such a model helps auditors organize a vast and at times confusing array of facts and bring order to their comprehension of the entity's organizational structure and behaviour. Because the model provides a common basis for understanding the organization, it serves as a useful means of communication within a multidisciplined group of auditors and between the auditors and auditees.

### **What is an audit model?**

Webster's dictionary defines a model as a "description or analogy used to help visualize something (as an atom) that cannot be directly observed". A model, therefore, is an abstraction, a simplification of a complex reality. It





assists in identifying key elements of the thing being described, as well as illustrating the interrelationships between those elements. An audit model is a simplified description, a concrete representation of the audit entity. It attempts to portray a comprehensive, dynamic overview of organizational activities. A successful audit model portrays those interactions in a manner that logically reflects the sequential flow of essential transactions, focuses attention on the important "driving" forces, defines the roles of the principal players and highlights the key management and financial controls at each step of the process examined.

Models used to identify a lack of controls must be more prescriptive and dynamic than those used in the more traditional form of audit - for example, the flowchart. In this sense they more closely resemble "standard" Internal Control Questionnaires which lead the auditor to compare controls which are in place with those which normally should be in place.

### **The modelling process: an example**

Conceptually, the modelling process involves two distinct phases: the development of a descriptive model that documents what "is", and the development of a predetermined control model that documents all the controls that "should be" in place to ensure the program or activity is operating properly. The predetermined control model contains the standards, or criteria, through which the actual auditee operations will be evaluated. The modelling process can be best illustrated by using a hypothetical case study of an audit - the previously mentioned government loan program.

The auditors' starting point during the planning phase of the audit is, as noted earlier, the question: "What business is the loan program in?" The auditors review the program's mandate and practices. After finding that the program, in fact, actively pursues loans in default, the auditors conclude that the entity is really in the loan business, not the welfare business. The auditors' efforts to gain the necessary knowledge of the business will then lead them through a bewildering array of statutes, financing instruments, political factors



# DESCRIPTIVE MODEL OF A LOAN PROGRAM

TABLE 1

LIFECYCLE OF A TYPICAL TRANSACTION				
ORGANIZATIONAL UNIT	INITIATION	APPROVAL	DISBURSEMENT	COLLECTION / FOLLOW-UP
HEADQUARTERS	INITIATES SENSITIVE LOANS	APPROVES LARGE LOANS	MAINTAINS OFFICIAL LOAN CARDS	MONTHLY RECONCILIATION
REGIONAL OFFICE	REVIEWS ALL REQUESTS	APPROVES SMALL LOANS	REGISTERS SECURITY	
DISTRICT OFFICE	LOAN OFFICER INITIATES PROJECT	N / A	DISTRIBUTES CHEQUE	DEPOSITS \$ / INVESTIGATES LATE PAYMENTS
CENTRAL AGENCY	N / A	APPROVES VERY LARGE LOANS	WRITES CHEQUE / REPORTS TRANSACTIONS	N / A





and transactions spanning various organizational units - districts, regions, headquarters and central agencies. Faced with a potential overload of apparently disjointed data about the who, what, where, why, when and how of the program, the auditors will search for an appropriate framework to organize the information gathered. Cognizant of the reality that it is impractical to model everything, the auditors will determine an appropriate level of detail for their model.

Building on their previous audits of financial organizations, the auditors will decide that the logical starting point is the universal life cycle of any loan: initiation, approval, disbursement, collection, follow-up and write-off. They visualize a matrix, such as in Exhibit I, that juxtaposes and matches those phases of a typical loan transaction with the key organizational units involved - headquarters, the regional offices, districts and applicable central agencies. For each box in the resulting matrix, the auditors will fill in a brief description of the activity performed and the control currently in place. At the end of this initial phase of modelling what "is," the auditors will have identified the controls on which management currently relies. This is illustrated in Exhibit I, Descriptive Model of a Loan Program. They will then test those controls during the execution phase of the audit, followed by a report to management on whether the controls are effectively preventing waste.

In the second phase of modelling, the auditors stand back and ask, "What additional controls should be in place?" at each phase of the life cycle of the loan, to ensure that:

- Loans are made only to viable businesses unable to obtain alternative financing.
- Loans are properly challenged and analysed prior to approval.
- Loans are disbursed only after security on assets is properly registered.
- All loan payments are collected and deposited and late payments are followed up in a timely manner.






# PREDETERMINED CONTROL MODEL OF A LOAN PROGRAM

TABLE 2

LIFECYCLE OF A TYPICAL TRANSACTION				
ORGANIZATIONAL UNIT	INITIATION	APPROVAL	DISBURSEMENT	COLLECTION / FOLLOW-UP
HEADQUARTERS	INITIATES SENSITIVE LOANS	APPROVES LARGE LOANS	MAINTAINS OFFICIAL LOAN CARDS	MONTHLY RECONCILIATION
REGIONAL OFFICE	PREPARES VIABILITY REPORT	APPROVES SMALL LOANS	REGISTERS SECURITY BEFORE CHEQUE ISSUE	PREPARES MONTHLY COLLECTIONS REPORT
DISTRICT OFFICE	LOAN OFFICER INITIATES PROJECT	N / A	DISTRIBUTES CHEQUE	DEPOSITS \$ / INVESTIGATES LATE PAYMENTS
CENTRAL AGENCY	N / A	APPROVES VERY LARGE LOANS	WRITES CHEQUE / REPORTS TRANSACTIONS	N / A

 MISSING CONTROL



It is this second phase of the modelling process that poses a unique challenge to the auditor and requires an ongoing and continuous process of collaboration and communication between the auditor and auditee. The auditor's dilemma is that he runs the risk of losing his objectivity and independence by getting involved in standard setting, rather than auditing. However, the purpose of this second phase is to identify potential gaps in management's established control framework, the existence of which will be proven, or disproven in the auditor's subsequent field work.

During that phase of the modelling process, the auditors draw on prior experience with other financial institutions, the formal procedures of similar organizations, discussions with auditee management, and general principles of sound financial administration. Controls that the auditors and management think should be in place to prevent waste form the basis of the matrix shown in Exhibit 2. Missing controls, such as the preparation of a formal viability report, are shaded. That model will provide a norm, or benchmark, against which to measure the entity's actual control practices.

### **The Field Work phase**

Starting with the predetermined control model developed in the second phase of planning, the auditors proceed to the execution (field work) phase of the comprehensive audit. They draw up an audit plan to (1) test whether key controls operate as designed and are effective and (2) gather sufficient appropriate evidence to support an analysis of the cause and effect of significant weaknesses, deficiencies and inefficiencies.

Now the auditors perform the traditional audit procedures designed to test compliance with existing management controls. Then, they go one step beyond: they audit the controls that they know do not currently exist but that they believe should exist. Their audit objectives, relative to each potential deficiency, are threefold:





1. To prove that the control, or relevant compensating control, does not exist.
2. To prove that significant opportunities are being lost.
3. To determine the causes and effects of the deficiency and make appropriate recommendations.

In the example of the loan program, the auditors' predetermined control model indicated that a control should be in place to ensure that cheques are not issued before a chattel mortgage is registered. During the field work, the auditors will compare the dates of cheque requisitions to the dates of security documents, analyse loans in default for cases where registration was omitted and determine program responsibility for ensuring that all loans are properly safeguarded.

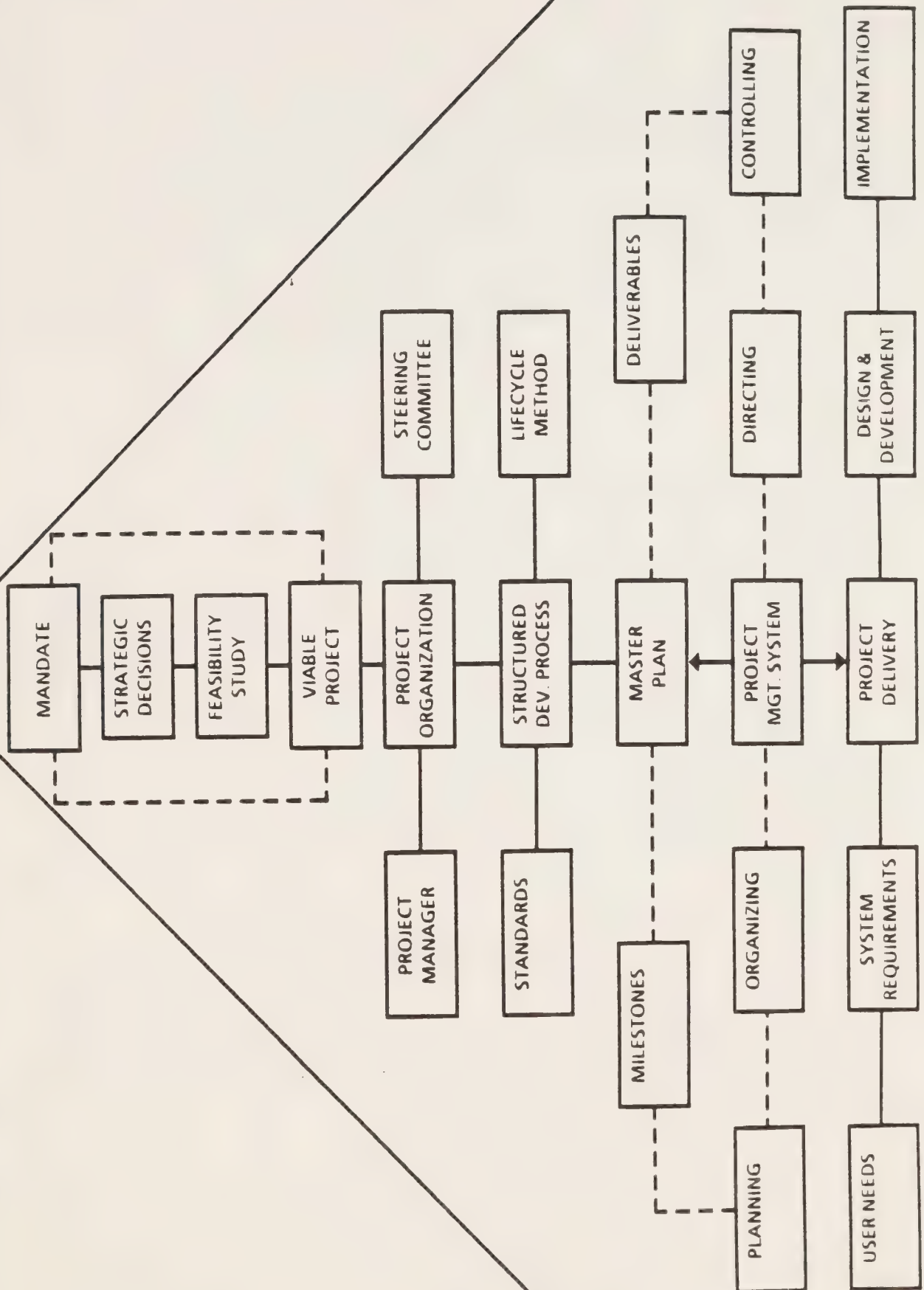
The final audit report will reflect the auditors' findings on the potential deficiency. Serious deficiencies compounded by cases of significant waste will lead the auditors to make recommendations designed to correct such omissions. The auditors will have audited a control that is not in place, and proved that it should be. The auditors' recommendation is not based on standards he has established, rather it is based on documented cases of waste that might have been prevented by a control not currently in place. Management then decides to set new standards, based on the auditors' findings.

### **An endless variety of models**

The audit model used to examine the ongoing management of a loan portfolio would not necessarily be appropriate for other entities. The loan program was typical of matrix organizations.

Entities characterized by hierarchical structures demand a different type of model, for example, one such as shown in Exhibit 3. A unique feature of that model is the series of top-down, cause-and-effect relationships that are









implicit in its pyramid structure. It depicts a hierarchy of potential fatal mistakes. If a clear mandate is missing, there is a high probability that all that rests below it will not be well implemented. Similarly, the absence of a project manager with overall accountability and authority for the day-to-day management of the project suggests that the lower-level planning and controlling activities will not be well handled. Effective use of this particular model will provide the auditors with a road map during the field work that would lead them to ask the right overview questions, identify serious weaknesses in project management and link these weaknesses with verifiable failures in results.

### **Good audit models**

In practice, there is an endless variety of specific audit models, each appropriate to unique audit environments. There are some common elements, however. A useful audit model should be self-correcting, relevant, simple and disposable. A good model is self-correcting because it leads auditors to ask the right questions and the answers to those questions lead the auditors to make the necessary revisions to their models. A good model is relevant because it focuses the auditors' attention on the important activities and outputs of the entity, not on peripheral or support activities. A good model is simple because it limits the number of potential choices, rather than presenting an unnecessarily complex array of issues to investigate. A good model is disposable because it does not lead the auditor to confuse the audit process with audit recommendations; it is a means to an end.

In the case of comprehensive auditing, a good audit model helps identify potential risk areas caused by missing controls. Auditors then test the model against reality - their objective is to recommend improvements in the management control framework in place to ensure the government provides the best services for the money spent.





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